

Income-splitting opportunities and the income attribution rules that may prevent them

Income splitting is the loaning or transferring of money to a lower-income person (for example, a spouse, common-law partner or child) so that the income or gains from investing the money are taxed at a lower tax rate, which decreases the overall tax burden of the family unit.

Income attribution rules generally block attempts to shift income to another person by attributing it back to the first person. While these rules eliminate most opportunities for income splitting, there are still a few left for income splitting within a family and these are covered below.

Income attribution rules

General rules

Attribution between spouses or common-law partners

The Income Tax Act (Canada) stipulates that where an individual has transferred or loaned property either directly or indirectly (by means of a trust or by any other means) for the benefit of the individual's spouse or common-law partner, or a person who has since become the individual's spouse or common-law partner, any income or loss from the property and any capital gain or loss on the disposition of the property will be attributed back to the individual.

This means that even though the spouse or common-law partner is now receiving the income, the individual still pays the tax on it at his/her marginal tax rate.

So the family is no better off than if the transfer or loan had not been made.

Attribution with respect to minor children

Income on property transferred or loaned, directly or indirectly (by means of a trust or by any other means), to a related minor child is attributed back to the transferor or lender.

This rule only applies if the child is under 18 at the end of the year. It generally does not apply to capital gains or losses on disposition of the property by the child.

Transactions covered by this attribution rule are those in which the taxpayer and child are “not dealing at arm’s length” – these generally include the taxpayer’s child, grandchild, great-grandchild, his/her spouse’s or common-law partner’s child, his/her child’s spouse or common-law partner, his/her brother, sister, brother-in-law, sister-in-law, and for the purposes of this rule include the taxpayer’s niece or nephew.

Attribution on loans to other family members

Attribution will also apply to loans, but not transfers, to other family members (such as children who are over 18) if one of the main reasons for the loan was to achieve income splitting and reduce taxes.

Loans for non-investment purposes, such as to pay tuition fees, are not covered by this attribution rule because no income is earned on these loaned funds.

Specific anti-avoidance rules

A series of more specific rules are included in the *Income Tax Act* to ensure that the general rules outlined above cannot be circumvented. They include the following:

Back-to-back loans and transfers

If a person loans or transfers property to a third party, who then loans or transfers it to his/her spouse or common-law partner or a related minor child, the situation will be treated as if that person had loaned or transferred the property directly and the attribution rules will apply.

Guarantees

Guaranteeing a loan for a spouse or common-law partner or related minor child who receives the loan only on the strength of the person’s guarantee, will cause the loan to be treated as if that person had loaned the funds directly. Attribution rules will therefore apply.

Repayment of an existing loan

If a loan (on which attribution applied) is paid off by receiving a second loan from the same person, the attribution rules will apply to the second substituted loan as if it were the original loan.

Transfers to a trust

Indirect transfers to a trust for the benefit of a spouse or common-law partner or related minor child will result in the attribution rules being applied exactly as if the transfers had been made directly to the spouse or common-law partner or minor child.

Income-splitting tax

In the February 1999 federal budget, the government announced that beginning in 2000, a new “income-splitting” tax at the prevailing top marginal tax rate – rather than at prevailing graduated rates – will be imposed on certain income of those under 18. Under the new rule, taxable dividends on shares of private (unlisted) companies – whether received directly or through a trust or partnership – will be subject to this new tax. Additionally, any income subject to this tax will not be eligible for any deductions (such as RRSP contributions) or credits, other than the dividend tax credit and foreign tax credit.

Note that this rule does not affect employment income nor does it apply to dividends received on publicly traded shares (which may be subject to normal income attribution rules). Capital gains earned by a minor through an in-trust account are also unaffected.

The rules also do not apply to:

- Income from property acquired on the death of a parent of the child
- Income from any property inherited by children with disabilities eligible to claim the disability tax credit or children in full-time attendance at a post-secondary institution, or to
- Children who have no parent resident in Canada for tax purposes in the year

Income-splitting opportunities

Capital gains and children

Attribution does not apply to capital gains earned on disposition of property by a child. So it could be advantageous to loan or transfer funds to a child to invest in assets that tend to generate more capital gains than income over time.

This will reduce the income attribution to the lender or transferor and ensure that the gains earned are taxed in the child's hands.

Child tax benefit

Like the old family allowance payments, the child tax benefits received by some families may be invested in the child's name without any attribution of income back to the parents.

Parents no longer receiving child tax benefits lose the advantage of having this source of funds available to invest for their children.

Canada Pension Plan benefits

Spouses or common-law partners who are each receiving their CPP benefits can get a portion of each other's pension, if they choose. Since each spouse or common-law partner pays income tax only on the amount he or she actually receives, this can be an effective income-splitting technique.

Income on income (secondary income)

The attribution rules apply to income from property that is transferred or loaned.

If this income is reinvested by the transferee or borrower, it will earn a secondary stream of income. This "secondary income" is not attributed back to the transferor or lender because it is not income from the transferred property. It will be taxed in the transferee's or borrower's hands.

It can therefore be advantageous to loan or transfer property to a spouse or common-law partner or minor and allow the income attribution to occur on the income from the original investment. Then that income can be removed from the account and invested elsewhere, where it continues to earn a secondary stream of income on which no attribution occurs. This secondary income is taxed in the hands of a lower-income family member. Of course, for this to work, the loan or transfer must be legally effective.

With this type of arrangement, the key is to maintain the two accounts so that attributed income and non-attributed income are accounted for separately.

One example where loans for value or transfers at fair market value may be beneficial could be with the transfer to the lower-income spouse or partner of stocks that pay dividends.

Loans for value/transfers at fair market value

If an individual makes a loan to a spouse or common-law partner or child, which the spouse or common-law partner or child uses to invest, and interest is charged on the loan at a rate at least equal to the Canada Revenue Agency's prescribed interest rate at that time, the attribution rules will not apply. The interest, however, must be paid each year or within 30 days after the end of the year for the attribution rules not to apply.

If a deadline for the interest to be paid is ever missed, that year's income and all future years' income will be attributed back to the lending individual.

If an individual transfers property at fair market value to a spouse or common-law partner or related minor child (and reports any resulting gain thereon) and receives back from the spouse or common-law partner or child, cash or property of equal fair market value as consideration, the attribution rules will not apply. It must be the spouse's or common-law partner's or child's own cash or property that is given as consideration and, if a loan is part of this consideration, it must have an interest charge on it as outlined above.

If the property is given to a spouse or common-law partner, the spouse or common-law partner would have to elect out of the automatic rollover, which generally deems the transfer to occur at cost.

While, on the surface, loans for value or transfers at fair market value do not appear to achieve any income splitting, it may sometimes make sense to transfer property at fair market value or loan funds and charge interest on the loan if an excess yield or capital gain can be earned. This avoids the attribution and, at the same time, puts a high-yield asset in the hands of a lower-taxed individual. The difference between the yield and the interest charged, or the future capital gain over the fair market value transfer price, will be taxed at a lower rate. The drawback is that any interest charged on the loan is treated as income to the lender.

Loan or transfer made to earn business income

If a loan or transfer is made to earn business income (as opposed to income from property such as interest, dividends, rent or royalties), attribution will not apply.

Payment of expenses and taxes for lower-income family members

One of the easiest ways to split some income is for the high-income earner to pay all of the family's daily living expenses. This leaves more income in the hands of the lower-income earners to invest, thereby increasing their investment income, which will be taxed at lower rates. Payments of taxes on behalf of other family members also fall into this category. These payments will not attract attribution since they are not invested (the payment goes to the government), and therefore there is no income that can be attributed back.

In-trust accounts

If a donor contributes to an in-trust account for a minor beneficiary and the account is designed to provide primarily capital gains (e.g., by investing in an equity mutual fund), the resulting taxes, if any, may be paid by the child, assuming the account is set up properly. Any income earned (i.e., interest, dividends) in that account would still be attributed back to the donor.

If the in-trust account is set up improperly, it is possible that both capital gains and income may be attributed back to the donor. For example, this may occur when the terms of the trust are such that the property may only be disposed of with the consent of, or in accordance with the direction of, the donor. The Canada Revenue Agency has generally interpreted this to mean that the provision will apply if the donor is also the trustee of the account. This would apply regardless of the relationship between the beneficiary and the donor.

For more information, ask for our Tax & Estate InfoPage on *In-Trust Accounts*.

Registered Education Savings Plans (RESPs)

Contributions may be made to an RESP to save for someone's higher education and, if certain conditions are met, the beneficiary may qualify to receive the Canada Education Savings Grant (CESG). There is a \$50,000 lifetime limit that can be contributed for any one person's education. While this can be a one-time contribution, it may be preferable to make contributions over a number of years in order to make best use of the CESG (which is subject to annual limits).

The contributions are not tax-deductible, but the contributor can withdraw these contributions at any time tax-free.

All income, growth and CESGs earned by these contributions remain tax deferred while in the plan. When this money is distributed in the form of educational assistance payments to help a beneficiary attend a qualifying program, it will be taxed as regular income in the beneficiary's hands, not the contributor's.

For more information, ask for our Tax & Estate InfoPage on *Registered Education Savings Plans* and our *RESP Frequently asked questions* piece, which discuss CESGs in more detail.

Salary to spouse or common-law partner or children

If a person carries on a business, either personally or through a corporation, some income splitting can be achieved by paying a salary to a spouse or common-law partner and/or children. You must ensure, however, that services are genuinely being provided and that the amounts paid in salary are reasonable in relation to these services.

Spousal Registered Retirement Savings Plans (Spousal RRSPs)

Contributions made to a spousal RRSP are deductible by the contributing spouse or common-law partner within the applicable contribution limits.

When the plan is converted to an annuity or RRIF on retirement, the money will be taxed in the hands of the beneficiary spouse or common-law partner with no attribution of income back to the contributing spouse or common-law partner.

Note: Attribution will apply to the contributing spouse or common-law partner if the beneficiary spouse or common-law partner withdraws more than the minimum amount from any spousal RRIF within three years of any contribution being made to any spousal RRSP.

Other circumstances

Canadian attribution rules will not apply if the transferor is a non-resident or becomes a non-resident; however, there may be different tax consequences in the transferor's country of residence.

Attribution between spouses or common-law partners will also cease to apply if the spouses or common-law partners separate or divorce.

Attribution will also cease on the death of the transferor or lender.

The last word

This Tax & Estate InfoPage gives only a brief overview of the attribution rules and the income-splitting opportunities that can still be achieved within these rules.

The attribution rules are very complicated, so before undertaking any income-splitting arrangement it is important to obtain professional advice and assistance so you avoid falling into the many pitfalls surrounding these rules. This is especially true where minors are involved because provincial laws vary with respect to the ability of minors to enter into a contract and trust arrangements may be necessary.

In any plan involving taxation, it is also necessary to maintain appropriate and well-documented records to support the transactions clearly.

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